

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLEE**

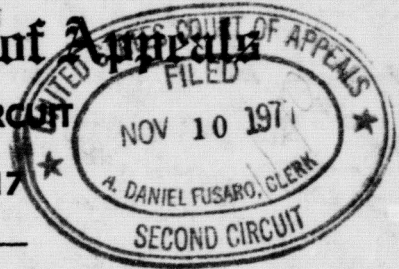
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77-6117

To be argued by
STUART I. PARKER

United States Court of Appeals
FOR THE SECOND CIRCUIT

Docket No. 77-6117



MEDITERRANEAN REFINING COMPANY,
Plaintiff-Appellant,
—against—

THE UNITED STATES OF AMERICA,
Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

**BRIEF FOR DEFENDANT-APPELLEE UNITED STATES
OF AMERICA**

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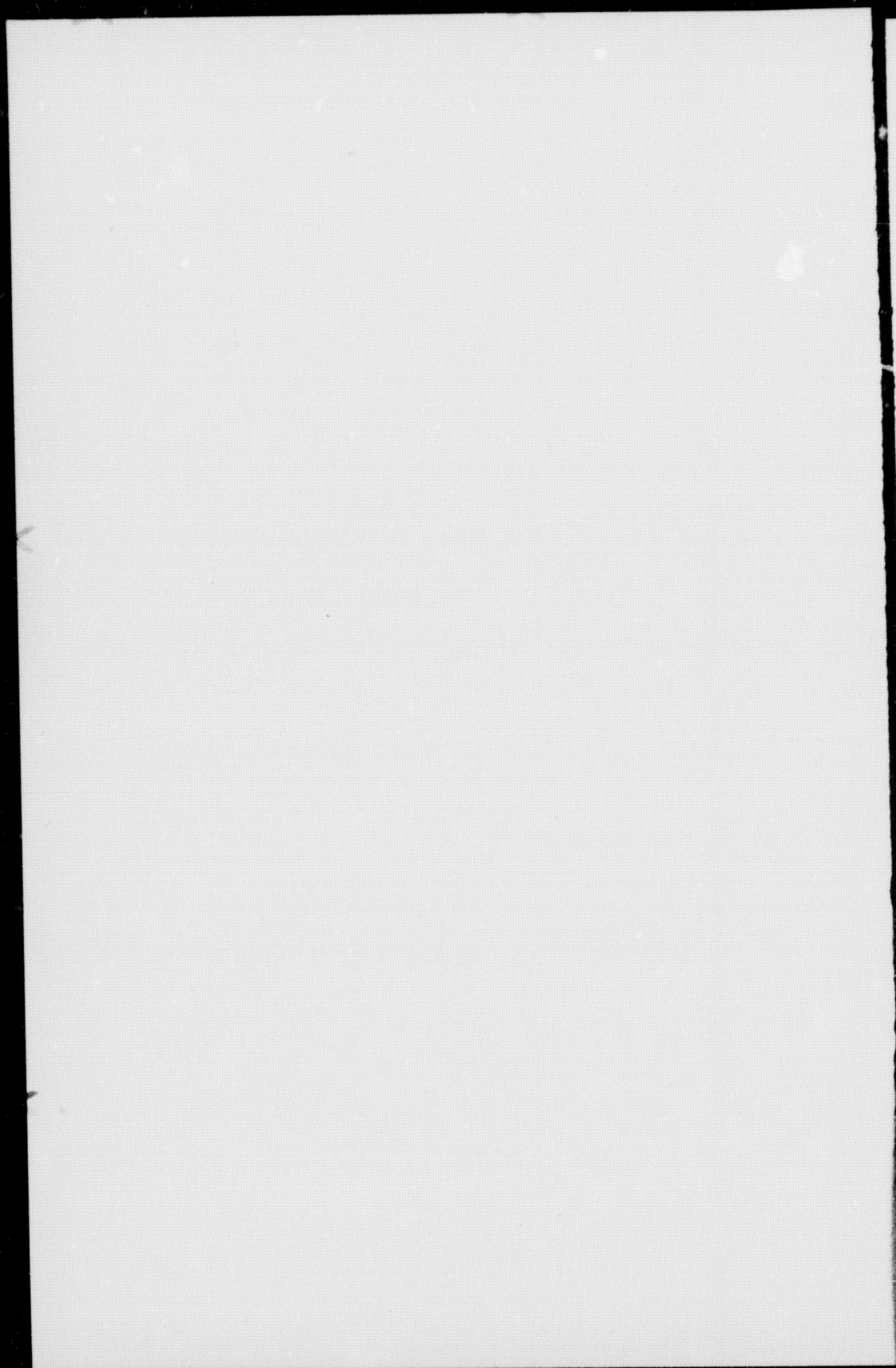


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Docket No. 77-6117

MEDITERRANEAN REFINING COMPANY,
Plaintiff-Appellant,
—against—

THE UNITED STATES OF AMERICA,
Defendant-Appellee.

**BRIEF FOR DEFENDANT-APPELLEE UNITED STATES
OF AMERICA**

Preliminary Statement

This is an appeal from a judgment entered on June 3, 1977 by the United States District Court for the Southern District of New York (Tenney, D.J.) dismissing an action brought by Plaintiff-Appellant Mediterranean Refining Company ("Mediterranean") for a refund of federal income taxes paid for the calendar year 1962.

By its complaint herein (2-4a),* Mediterranean has claimed that the Defendant-Appellee United States of America through the Internal Revenue Service (the "Government") wrongfully denied it a foreign tax credit for the tax year 1962 with respect to income taxes as-

* References are to pages in the Joint Appendix.

sessed against it by the Republic of Lebanon in 1966, even though for more than ten years since that assessment Mediterranean has neither paid any portion of the assessed tax nor resolved its tax contest with Lebanon over that assessment. In March, 1977 Mediterranean moved before the District Court to transfer this action to the suspense calendar and the Government cross-moved for summary judgment to dismiss the action on the grounds that Mediterranean had failed to state a claim and that the District Court lacked subject matter jurisdiction (12-13a). In a Memorandum filed May 31, 1977, the District Court denied Mediterranean's motion and granted the Government's motion on the ground that Mediterranean had failed to state a claim for a tax refund (16-20a). On June 3, 1977, judgment was entered dismissing the action with prejudice (21a).

Issue Presented

Did the District Court err in holding that Mediterranean had failed to state a claim under 26 U.S.C. § 901 *et seq.* for a foreign tax credit.

Statement of Facts

In 1962, the tax year at issue in this case, Mediterranean derived its income entirely from the operation of a petroleum refinery in Lebanon and the sale of petroleum products in that country (Complaint, ¶ 5, 2a).^{*} On or before March 15, 1963, Mediterranean filed a United States tax return for the year 1962 and paid United States income taxes for that year in the amount of \$407,311.54 (Complaint ¶ 3, 2a; Defendant's Rule 9(g) Statement, ¶ 2, 14a).

^{*} For the purpose of the Government's motion, this allegation in the complaint was assumed to be true.

Mediterranean alleges that in February, 1966 the Lebanese Government made an assessment for income taxes on its income for the calendar year 1962 in an amount equal to \$347,586 (Complaint, ¶ 6, 3a). In the more than ten years since the assessment, Mediterranean has never paid any portion of that amount (Defendant's Rule 9(g) Statement, ¶ 1(a), 14a). According to Mediterranean, it has contested this income tax assessment and, until September, 1973, engaged in a series of negotiations regarding the assessment with representatives of the Lebanese Government (*Id.*, ¶ 1(b), 14a). At that time, as alleged by Mediterranean, these negotiations "were interrupted due to the political situation and civil strife prevalent in Lebanon" (Answer to Interrogatory 1(c), 10a). Thus, at this time, approximately 15 years after the end of the tax year involved, ten years after the alleged Lebanese assessment, and four years after the last negotiations with Lebanon, the tax contest remains unresolved,* with no part of the assessment having been acquiesced to or paid by Mediterranean.

On March 13, 1973, despite the unresolved nature of tax dispute with Lebanon, Mediterranean filed with the United States Internal Revenue Service a claim for an income tax refund of \$347,586 for the calendar year 1962, alleging that it was entitled to a foreign tax credit in that amount for the Lebanese income tax assessment for 1962 ** (Complaint, ¶ 7, 3a). Mediterranean's claim

* The nature of the tax contest is described by Mediterranean in its answer to Interrogatory 1(c) (10-11a). It appears that Mediterranean is claiming exemption from taxation under a convention it entered into with the Lebanese Government in 1945 and the Lebanese Government is claiming that Mediterranean's exemption was terminated by a law enacted by the Lebanese Parliament in 1956.

** As noted above, \$347,586 is the dollar amount of the alleged Lebanese income tax assessment for 1962.

for an income tax refund was rejected on November 7, 1973 (*Id.*, ¶ 8, 3a; Answer ¶ 5, 6a) and on October 29, 1975 the instant action was commenced.

ARGUMENT

Mediterranean Is Not Entitled To A Foreign Tax Credit For The Calendar Year 1962.

A. Statutory Scheme

The foreign tax credit which Mediterranean seeks is "an act of grace on the part of Congress, and one who seeks the benefits of its provisions must plainly establish his right by showing that he has fulfilled all the conditions upon which the allowance of the credit is made to depend." *Irving Air Chute Co. v. Commissioner*, 143 F.2d 256, 259 (2d Cir.), *cert. denied*, 323 U.S. 773 (1944). Under 26 U.S.C. § 901(b)(1) a domestic corporation, such as Mediterranean, is allowed a credit against its federal income tax in

the amount of any income, war profits, and excess profits taxes *paid or accrued during the taxable year to any foreign country* . . . (emphasis added).

As the District Court properly observed (Memorandum, 18a), the burden is on the taxpayer to establish the amount of the foreign tax paid or accrued, 26 U.S.C. § 905(b), and as noted in *United States v. Campbell*, 351 F.2d 336, 338 (2d Cir. 1965), *cert. denied*, 383 U.S. 907 (1966):

In the event the foreign tax is contested by the taxpayer, the Internal Revenue Service has followed *Cuba R.R. v. United States*, 124 F. Supp. 182 (S.D.N.Y. 1954), which requires a taxpayer on an accrual basis to accrue a foreign tax lia-

bility as a credit against United States tax in the year in which this liability has been finally determined. However, this accrual has been allowed to "relate back" to the year in which the foreign tax was levied. Rev. Rul. 58-55, 1958-1 Cum. Bull. 266. Thus, if the taxpayer contests his liability for a foreign tax imposed on income in 1960, and this liability is finally adjudicated in the foreign country in 1965, "the credit may not be claimed until 1965 * * *, [but] the foreign tax imposed on 1960 income will be offset against the United States 1960 tax just as if it had accrued in 1960." Owens, *The Foreign Tax Credit* 5/3B2, at 328 (1961).

In addition, a taxpayer claiming a foreign tax credit by reason of taxes "paid or accrued to any foreign country" must file a claim for credit within ten years from the filing date for the tax return for which the foreign tax credit is claimed. 26 U.S.C. § 6511(d)(3)(A).

In summary, 26 U.S.C. §§ 901(b)(1), 905(b) and 6511(d)(3)(A) make clear that a foreign tax credit is only available for foreign taxes which have been paid or accrued. And, in regard to a contested foreign tax liability, accrual "cannot be made until the contested liability is finally determined." Rev. Rul. 58-55, 1958-1 Cum. Bull. 266, 267 (1958). However, once a contested foreign tax liability has accrued (that is, has been finally determined) the taxpayer may relate the accrual back to the year for which the foreign tax was assessed. Rev. Rul. 58-55, *supra*. Finally, unless the foreign tax contest is resolved and the claim for foreign tax credit is made within ten years of the date for filing the income tax return for the year for which the credit is claimed, the taxpayer's foreign tax credit claim is time barred by 26 U.S.C. § 6511(d)(3)(A).

B. Mediterranean's Claim

As the District Court correctly concluded (Memorandum, 19-20a), Mediterranean has not met the most basic condition for claiming a foreign tax credit—it has failed to predicate its claim for a foreign tax credit on either the actual payment or final determination of a foreign tax. As Mediterranean admits (10-11a, 14a), the tax contest with the Lebanese Government regarding the 1962 income tax assessment still remains unresolved. Thus, the District Court held:

Since it appears that the plaintiff is not certain to pay taxes to the foreign government, this Court cannot conclude that the taxes have "accrued" within the intendment of the statutory allowance of a tax credit, and therefore the request for a refund is denied. This result accords with the purposes and policies of the United States tax laws which seek to tax earned income yet spare the taxpayer the burden of double taxation, while simultaneously encouraging the prompt resolution of disputed foreign tax claims (19-20a).

Mediterranean nonetheless urges this Court to hold that for purposes of claiming a foreign tax credit a contested foreign tax may be accrued when that tax is assessed. Mediterranean points to no cases or other authorities which support its position, but simply argues that no other result would be fair. In that connection, Mediterranean points out that if its position is not adopted it will be forever precluded by 26 U.S.C. § 6511 (d)(3)(A) from taking a foreign tax credit for 1962 based on the Lebanese tax assessment. Mediterranean also argues that the Government will not be harmed if the assessment is treated as an accrual since 26 U.S.C. § 905(c) permits the Government to recover any amount plus interest which the resolution of the Lebanese tax

contest indicates Mediterranean should not have received as a foreign tax credit.

Mediterranean's arguments must be rejected. It is settled case law that a contested liability may not be accrued until the contest is resolved. *Dixie Pine Products Co. v. Commissioner*, 320 U.S. 516, 519 (1944); *United States v. Consolidated Edison*, 366 U.S. 380 (1961); *Poirier & McLane Corp. v. Commissioner*, 547 F.2d 161 (2d Cir. 1976). This aspect of what is commonly referred to as the "contested tax doctrine" specifically has been applied by Revenue Ruling 58-55 to the foreign tax credit. The ruling also provides that once accrued, the foreign tax may only be credited against the taxable year to which it relates. As one noted commentator has observed:

[Revenue Ruling 58-55] holds that, when applying the [foreign] tax credit provisions, contested taxes accrue at two different times for two different purposes. For the purpose of determining in what year the right to claim the credit arises, the "contested tax" doctrine is applied. For the purpose of determining against which United States tax the foreign tax is to be credited, the "contested tax" doctrine does not apply and the contested tax is held to have accrued in the taxable year "to which the tax relates". E. Owens, *The Foreign Tax Credit* ¶ 5/3B2 at 328 (1961).*

* Revenue Ruling 58-55 reads in pertinent part as follows:

It is to be noted that the provisions [of the foreign tax credit] are strictly statutory and do not relate to usual accounting practice. Section 905(c) of the 1954 Code and section 131(c) of the 1939 Code provide a separate and distinct method of correcting differences in taxes claimed as a credit and taxes finally paid. Under these provisions the Commissioner may call for additional taxes due by notice and demand without facing the bar of the ordinary

[Footnote continued on following page]

We are aware of only two cases considering the issue of when an accrual can be made under the foreign tax credit statutory scheme. The first is *Cuba Railroad Co. v. United States*, 124 F. Supp. 182 (S.D.N.Y. 1954), upon which Revenue Ruling 58-55 is based. The second is *United States v. Campbell*, *supra*, in which this Court seems to accept as existing law the accrual rule set forth in Revenue Ruling 58-55. Mediterranean has cited to no cases indicating that a contested foreign tax may be accrued when assessed.

statute of limitations. Similarly, section 6511(d)(3) of the 1954 Code, which provides a ten-year statutory period of limitations, with respect to refunds relating to the credit for foreign taxes, evidences Congressional intent of separate treatment of the foreign tax credit.

However, the accrual of foreign taxes, for the purpose of the foreign tax credit under section 901 of the 1954 Code and section 131 of the 1939 Code, must conform to the general rules laid down under section 461 of the 1954 Code or section 43 of the 1939 Code. Under such rules the accrual for the contested taxes cannot be made until the liability is finally determined, but, under the principles stated in *The Cuba Railroad Company* case, and in view of the special nature of the foreign tax credit as evidenced by its legislative history and concept, such accrual will relate back to the taxable year for which the foreign tax is in dispute.

Accordingly, in view of the statutory framework, the legislative history and the concept of the foreign tax credit, it is held that the "contested tax" doctrine as expressed in the *Dixie Pine Products Company* case is not applicable to the accrual of a foreign tax for the purpose of the credit under section 901 of the 1954 Code or section 131 of the 1939 Code. A foreign tax for the purpose of such credit is accruable for the taxable year to which it relates even though the taxpayer contests the liability therefor and such tax is not paid until a later year. Such accrual, however, cannot be made until the contested liability is finally determined. Rev. Rul. 58-55, 1958-1 Cum. Bull. 266, 267.

Mediterranean's argument is also contrary to accepted principles of statutory construction. The foreign tax credit provisions now in issue were contained in Section 131 of the Internal Revenue Code of 1939 and were re-enacted by Congress in 1954. By 1954, it was well settled case law:

That a taxpayer may not accrue an expense the amount of which is unsettled or the liability for which is contingent and this principle is fully applicable to a tax, liability for which the taxpayer denies, and payment whereof he is contesting.

Security Flour Mills Co. v. Commissioner, 321 U.S. 281, 284 (1944); *Dixie Pines Products Co. v. Commissioner*, *supra*; *Baltimore & Ohio Railroad Co. v. Magruder*, 174 F.2d 896 (4th Cir.), *cert. denied*, 338 U.S. 828 (1949); *Brighton Mills, Inc. v. Commissioner*, 161 F.2d 791 (5th Cir. 1947). In Revenue Ruling 58-55, the Commissioner left unchanged the principle that accrual may not be made until after a tax contest is resolved. During the almost twenty years Revenue Ruling 58-55 has been in effect the foreign tax credit provisions to which it applies have remained substantially unchanged. Under these circumstances, we submit that the ruling's determination of when a contested foreign tax may be accrued should be "deemed to have received congressional approval and have the effect of law." *Helvering v. Winmill*, 305 U.S. 79, 83 (1938). See *United States v. Correll*, 389 U.S. 299 (1967); *First National City Bank v. United States*, 77-2 USTC ¶ 9527 at 87,741 (Ct. Cl. 1977).

The requirement that Mediterranean either resolve its tax contest with Lebanon or pay the Lebanese tax assessment before claiming a foreign tax credit is neither unfair nor inconsistent with the purposes of the foreign tax credit statutory scheme. Although the primary purpose of the foreign tax credit provisions is to prevent double

taxation of income earned and taxed abroad, Congress also took into account the strong governmental interest that tax liabilities in the United States be finally determined within a definite time period. In balancing these two interests, Congress specifically provided a ten instead of a three year limitations period for claiming a tax refund based on entitlement to a foreign tax credit. 26 U.S.C. § 6511(d)(3)(A).^{*} Given the length of this special statute of limitations, it hardly seems unfair to require a taxpayer to resolve a foreign tax contest or pay the disputed tax within the limitations period if it wishes to obtain the benefits of a foreign tax credit.

The statutory scheme of 26 U.S.C. § 901 *et seq.* and 26 U.S.C. § 6511(d)(3)(A) for allowance of a foreign tax credit puts a taxpayer contesting a foreign tax assessment on notice that if it wishes to claim such a credit, it must resolve that contest or pay the foreign tax within the limitations period provided by 26 U.S.C. § 6511(d)(3)(A).^{**} Thus the taxpayer is provided with an incentive to resolve foreign tax contests expeditiously. If, as Mediterranean urges, a taxpayer were permitted to

^{*} That section provides in pertinent part as follows:

If the claim for credit or refund relates to an overpayment attributable to any taxes paid or accrued to any foreign country . . . for which credit is allowed . . . in accordance with the provisions of section 901 . . . in lieu of the 3-years period of limitations prescribed in subsection (a), *the period shall be 10 years from the date prescribed by law for filing the return for the year with respect to which the claim is made.* (emphasis added)

^{**} Contrary to Mediterranean's argument at page 7 of its brief, Revenue Ruling 58-55 recognizes, as did the District Court (Memorandum, 19-20a), the importance of the statute of limitations in the foreign tax credit statutory scheme and indeed makes specific reference to 26 U.S.C. § 6511(d)(3). (See pp.7n* above)

take a foreign tax credit on an unpaid and contested foreign tax assessment, there would be no such incentive. Indeed, a taxpayer might well be encouraged to allow foreign tax disputes to linger. This is because the taxpayer would immediately receive a tax credit equal to the full amount of the contested foreign tax assessment, without having paid or conceded any portion thereof, and until resolution of the contest would have full use of the credited amount. While it would be true under Mediterranean's analysis that at the conclusion of the contest the taxpayer, if successful, would have to adjust the amount of the foreign tax credit taken in accordance with 26 U.S.C. § 905(c) and pay the Government statutory interest on the amount improperly credited, it is likely that the taxpayer would consider the statutory interest a bargain price to pay for open-ended use of the amount initially credited.*

In sum, it would be contrary to both well-settled principles of tax law and the congressional purposes underlying the foreign tax credit statutory scheme to permit Mediterranean to claim such a credit based on a foreign tax assessment which remains unpaid and contested. Accordingly, we submit the District Court's holding that Mediterranean failed to state a claim for a tax refund was correct.

* Presently the statutory rate of interest set pursuant to 26 U.S.C. § 6621, Treas. Reg. § 301.6621-1(b) and Rev. Rule 75-487, 75-2 Cum. Bull. 488 (1975), is 7%.

We further note that § 905(c), as do §§ 901 and 6511(d)(3)(A), speaks of "accrued taxes", a term which as we have shown has a clear and precise meaning under the foreign tax credit statutory scheme, *i.e.*, taxes which are "finally determined". Since the Lebanese tax assessment which Mediterranean wishes to claim as a credit has not yet been finally determined, § 905(c) has no application to this case.

CONCLUSION

For all of the above reasons, Defendant-Appellee respectfully requests that the judgment of the District Court be affirmed.

Dated: New York, New York
November 10, 1977

Respectfully submitted,

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AFFIDAVIT OF MAILING

State of New York)
County of New York) ss

Marian J. Bryant being duly sworn,
deposes and says that she is employed in the Office of the
United States Attorney for the Southern District of New York.

That on the
two copies
10th day of November 19 77 she served ~~copy~~ of the
within Appellee's Brief

by placing the same in a properly postpaid franked envelope addressed:

Andrew J. Azzara, Esquire
380 Madison Avenue
New York, New York 10017

And deponent further says s he sealed the said envelope and placed the same in the mail chute drop for mailing in the United States Courthouse Annex, One St. Andrews Plaza, Borough of Manhattan, City of New York.

Sworn to before me this

10th day of November, 19 77

PAULINE P. TROIA
Notary Public, State of New York
No. 31-4632381
Qualified in New York County
Commission Expires March 30, 1978

Marion J. Bryant

